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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No. 286

ALABAMA-TENNESSEE NATURAL GAS COMPANY,
Petitioner,

v.

FEDERAL POWER COMMISSION, TENNESSEE VALLEY MUNICIPAL GAS ASSOCIATION, *Respondents.*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF FOR THE TENNESSEE VALLEY MUNICIPAL GAS ASSOCIATION IN OPPOSITION

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OPINIONS BELOW

The opinion of the Court of Appeals for the Fifth Circuit (Pet. App., pp. 1a-43a) is reported at 359 F. 2d 318. The opinions of the Federal Power Commission (R. 126-177, 202-214) are reported at 31 FPC 208 and 31 FPC 928.

JURISDICTION

The judgment of the court below was entered on March 25, 1966 (Pet. App. p. 44a). The petition for a writ of certiorari was filed on June 23, 1966. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTIONS PRESENTED

1. Whether Congress in enacting Section 167 of the Internal Revenue Code, which gives taxpayers the right to use "liberalized depreciation" for tax purposes, thereby circumscribed the Federal Power Commission's right to fix just and reasonable rates under the Natural Gas Act on the basis of the utility's actual tax liability resulting from the use of "liberalized depreciation".

2. Whether Petitioner was denied the opportunity to present evidence in support of an allowance for federal income taxes in excess of Petitioner's actual tax liability.

STATUTES AND REGULATIONS INVOLVED

Relevant portions of the Natural Gas Act, the Administrative Procedure Act, and the Federal Power Commission's Rules of Practice and Procedure are set forth in the appendix to the Federal Power Commission's Brief in Opposition to the Petition.

STATEMENT

The Tennessee Valley Municipal Gas Association ("Association") is an unincorporated association. Its membership consists of ten Alabama, Mississippi, and

Tennessee municipalities,[1] each of which is engaged in the distribution and sale of natural gas at retail in their respective communities and environs.[2]

Each of the municipalities purchases its natural gas requirements from Petitioner at rates and charges which are subject to the jurisdiction of the Federal Power Commission ("Commission") under the Natural Gas Act, as amended. The Association's members account for over 80 per cent of Petitioner's sales of natural gas subject to the Commission's jurisdiction (Pet. App., p. 38a).

Petitioner filed four successive increases in its rates and charges to the Association's members. The Association was granted intervention in the proceedings by the Commission. At the consolidated hearing on the four rate increases, and in all subsequent phases of the administrative process, and in the court below, the Association was an active participant.

For federal income tax purposes, Petitioner takes a deduction for depreciation on the basis of one of the liberalized tax depreciation methods—the declining balance method[3]—permitted by Section 167 of the

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[1] *Alabama:* Athens, Decatur, Florence, Huntsville, Russellville, Sheffield, and Tuscumbia. *Mississippi:* Corinth and Iuka. *Tennessee:* Selmer.

[2] On July 14, 1966, the Association, an intervenor before the Federal Power Commission and the court below, filed in this Court a motion to be added as a respondent.

[3] Under the declining balance method the depreciation rate is applied to the cost of the property less accumulated depreciation. The initial first year rate can be twice the straight line rate. Assuming an automobile costing $2,000 and having a 5-year life, the first year's depreciation would be at 40 percent, twice the straight line rate, or $800. In the second year the 40 percent would be applied to $1,200 ($2,000 less $800) for an accrual of $480. The same procedure would be followed in the balance of the 5-year life. By contrast, under the straight line method, in the example given, the depreciation accural is $400 per year or at a constant rate of 20 percent per year. (R. 8-9).

Internal Revenue Code (26 USC 167). (R. 7, 9). As a result, Petitioner's deduction for tax depreciation is larger—and its tax liability smaller—than would be the case under the straight line method of depreciation which taxpayers, including Petitioner, were using prior to the enactment of Section 167 (R. 7).

Petitioner computed its increased rates, however, on the basis of a hypothetical, larger federal income tax liability related to the use of the smaller straight line method depreciation deductions. This was in accord with the rate-making policy the Commission had adopted sometime after Section 167 was enacted.

Under this policy, known as the "normalization" method, the Commission permitted utilities subject to its jurisdiction to include in cost of service taxes computed on the basis of using straight line depreciation deductions although they paid less taxes based on the use of liberalized depreciation tax deductions. This policy required consumers to pay higher rates on the basis of a hypothetical federal income tax liability in excess of the utility's actual tax liability.

Under the "normalization" method, a Reserve for Accumulated Federal Income Taxes was established to which was credited the difference between the actual taxes paid and the larger hypothetical amount for taxes. The theory was that in the later years of the property life depreciation deductions would be smaller under liberalized depreciation; that taxes consequently would be higher; and that the reserve in later years would be drawn upon to meet these higher taxes. In the meantime, the excess payments required of the ratepayers were available for all corporate purposes other than the payment of dividends or transfer to earned surplus.

At the hearing, the Association opposed the rate increases and the "normalization" method. The Association presented expert testimony in support of its position that the Commission was in error in following the "normalization" method in fixing natural gas rates, should abandon that method, and should compute Petitioner's federal income tax allowance for ratemaking purposes on the basis of the liberalized depreciation deductions Petitioner actually takes in filing its tax returns (R. 6-37). This is known as the "flow-through" method because the benefits of the use of liberalized depreciation deductions—the taxes saved —are "flowed through" to the consumer in lower rates.

The expert testimony presented by the Association in this case (R. 6-37) established that the use of liberalized depreciation tax deductions produces a tax saving rather than a tax deferral as the "normalization" method assumed; that sound regulatory principles required the allowance of only actual taxes; that such allowance works no discrimination between generations of rate payers, produces no instability of rates; would not jeopardize the financial integrity of the Petitioner; nor impede its ability to attract capital and to expand. The witness pointed out, in general, that the allowance of actual taxes enhances the ability of utilities to compete for markets by reason of the resulting lower rates.

The Association's expert witness was subjected to cross-examination by Petitioner's counsel (R. 37-42; Tr. 1404-1410, 1419-1425, 1446-1448),[4] but Petitioner presented no evidence in support of its contention,

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[4] "Tr." followed by the page numbers refers to the portion of the record certified to, but not printed in the court below.

electing to stand on the Commission's "normalization" policy as set forth in Opinion No. 326, issued August 10, 1959, in *El Paso Natural Gas Company,* 22 FPC 260.

The Examiner's decision (R. 57-60; 27 FPC 1202-1240), issued September 15, 1961, disallowed $515,000 of the increased rates, but rejected the Association's contention respecting the computation of the federal income tax allowance. The Examiner, following the "normalization" method, included in cost of service a hypothetical tax allowance, in excess of Petitioner's actual tax liability, which he computed by using the smaller straight-line deductions for depreciation instead of the larger liberalized depreciation deductions actually used for tax purposes by Petitioner.

The Association filed exceptions to the Examiner's decision (R. 61-63). The Association urged reconsideration by the Commission of its use of the normalization method. The Association directed the Commission's attention to its brief in opposition to California's petition for a writ of certiorari to review the Fifth Circuit's affirmance of a Commission order employing the normalization method,[5] where the Commission had said that the choice between "normalization" and "flow-through" was "only a discretionary choice among competing accounting systems" which did not warrant review by this Court and was a choice "which can be changed by the Commission should it become convinced that the other method is preferable." (FPC Brief in Opposition, *California* v. *Federal Power Commission,* No. 599, October Term 1960, pp. 11-12.)

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[5] *El Paso Natural Gas Company* v. *Federal Power Commission,* 281 F. 2d 567 (CA 5), certiorari denied, *sub nom. California* v. *Federal Power Commission,* 366 U.S. 912.

Thereafter, on June 1, 1962, the Commission issued an order in these proceedings severing the issue of the rate treatment to be accorded the use of liberalized depreciation from the other issues "because the Commission determined that it was appropriate to re-examine and re-evaluate" its policy "in light of" the Commission's more recent experience (R. 126); fixed a date for oral argument on the severed issue; and provided for briefs and the participation of interested parties as *amici curiae*. (R. 64). On June 13, 1962, the Commission issued a decision disposing of the other issues in the rate proceedings in order to produce "immediate refunds and rate reductions associated with these issues" (R. 67-98). The Commission fixed the interim rates on the basis of its existing "normalization" policy, because any change in its policy would be given only prospective effect (R. 88).

On May 16, 1963, Petitioner, the Association, and numerous amici participated in the oral argument on the liberalized depreciation issue. Thereafter, on February 3, 1964, in a three to two decision (R. 126-154), the Commission held that Petitioner's rates should be based on actual taxes paid (the flow-through method) and no longer on the basis of a hypothetical tax liability (the normalization method). On the basis of the allowance in cost of service of Petitioner's actual income tax liability, reflecting its actual tax deductions for depreciation, the Commission ordered a further reduction in rates of approximately $44,000 to consumers.

The Commission found (R. 153) upon "reexamination of the present policy of basing income tax allowances for a company which pays taxes calculated under liberalized depreciation on the deductions available

under straight line depreciation", that "there is no present factual justification for thus normalizing the prospective rates of Alabama-Tennessee" and that, therefore, its "rates should reflect only the actual taxes currently payable during the applicable test year in Docket No. G-19984 herein."

The Commission held that the choice between normalization and flow-through must not be based on "mere speculation and conjecture" but upon a "definite probability of higher future tax payments . . . in the reasonably foreseeable future" (R. 144, see also: R. 139). For rates "must be based upon presently known facts and factually based projections of pertinent future conditions" (R. 139).

It was necessary, therefore, "to evaluate the present necessity for continued rate normalization in the light of all pertinent facts and circumstances, affecting the likelihood that Alabama-Tennessee and other pipelines similarly situated will be faced with an actual increase in future taxes as a result of their current use of liberalized depreciation" (R. 144).

The Commission noted (R. 142) that this was the first case in which it "deemed itself legally free to bring its expertise to bear on the resolution of this factual issue," because prior to the decision of the court below in the *El Paso* case, *supra,* 281 F. 2d 567 the Commission had considered itself bound to follow normalization procedures due to an erroneous conclusion that Congress intended by Section 167 to deny to the Commission the right to determine the regulatory consequences of liberalized depreciation.

Reviewing the evidence, the Commission found (R. 143), that normalization is "premature and unneces-

sary as long as there is growth in the size of the dollar investment in gross plant," and even where gross plant investment levels off, unless in the latter situation leveling off "is shown to be the likely precursor of a decline in the plant."

Under conditions of growth and stability of investment, normalization forces the ratepayers "to provide funds to pay a hypothetical tax liability which may never become payable or, at the very least, to provide such funds many years in advance of the time when they are needed." (R. 143). In this connection, the Commission noted that between 1954, when Section 167 was enacted, and the end of 1962, forty of the larger natural gas pipeline companies subject to its jurisdiction had amassed $272,027,245 (R. 143), representing funds contributed by ratepayers under the normalization method for hypothetical tax liabilities that may never materialize. Petitioner's deferred tax reserve had increased from $17,481 in 1956 to $213,651 in 1963.

The Commission found also that the use of liberalized depreciation deductions for tax purposes "results in a permanent reduction of taxes payable to the Treasury Department by natural gas pipelines which maintain either a growing or stable plant" (R. 152); found as to Alabama-Tennessee that "the pattern of growth in demand and plant capacity . . . will continue for the reasonably foreseeable future" (R. 145-146); and found that "Alabama-Tennessee will maintain a growing or stable plant for the foreseeable future" (R. 152).

The Commission further found (R. 148) "that flow-through, rather than normalization, is the ratemaking treatment of the liberalized depreciation tax saving which, by permitting lower prices, will stimulate in-

creased consumer demand and corresponding additional investment in the pipeline industry as a whole and Alabama-Tennessee in particular." (See also R. 152).

Petitioner filed a timely application for rehearing which was denied (R. 100-109). Thereafter, it filed a timely petition for review.

The court below, in a unanimous decision, affirmed the Commission decision in all respects.

ARGUMENT

Petitioner rests its petition on two propositions, urged upon and correctly rejected by, the court below. The first is that Congress in enacting Section 167 intended to circumscribe the Commission's administrative discretion and expert judgment to determine and adopt the appropriate ratemaking principles under the Natural Gas Act (Pet., p. 11). The second is that Petitioner was denied procedural due process of law in that it did not have "adequate notice or opportunity . . . to cross-examine or submit rebuttal evidence" on the choice of methods (Pet., p. 11)

Nowhere in its petition does Petitioner challenge the Commission's findings that the use of liberalized depreciation produces a permanent tax saving, and not merely a tax deferral, as long as there is a growing or stable plant; that Petitioner will maintain a growing or stable plant for the foreseeable future; and that "there is no present factual justification for . . . normalizing the prospective rates of Alabama-Tennessee . . ." (R. 145-146, 152, 153). For normalization "during a period of growth or stability would force the ratepayers to provide funds for a hypothetical tax liability that might never become payable, or at the very least,

to provide funds many years in advance of the time they are needed" (Pet. App., p. 28a).

1. The court below twice (in the present case and in *El Paso Natural Gas Company* v. *Federal Power Commission*, 1960, 281 F. 2d 567, certiorari denied, 366 U.S. 912 (1961)), and two other courts of appeals (the Fourth Circuit in *Cities of Lexington, et al., Kentucky* v. *Federal Power Commission*, 1961, 295 F. 2d 109; and the D.C. Court of Appeals in *Panhandle Eastern Pipe Line Company* v. *Federal Power Commission*, 1963, 316 F. 2d 659, certiorari denied, 375 U.S. 881) have held that Congress did not intend by Section 167 to amend or modify the Natural Gas Act and thereby deprive the Commission of its discretion to choose the ratemaking principles which, in its expert and informed judgment, accord with the standards and objectives of the Natural Gas Act to "protect consumers against exploitation at the hands of the natural gas companies." (*Federal Power Commission* v. *Hope Natural Gas Company*, 1944, 320 U.S. 591, 611) and to "afford consumers a complete, permanent, and effective bond of protection from excessive rates and charges" (*Atlantic Refining Company* v. *Public Service Commission*, 1959, 360 U.S. 378, 388).

In the *El Paso* case, *supra*, the court below, accepting the Commission's erroneous view that the use of liberalized depreciation produced a tax deferral rather than a tax saving, approved the Commission normalization method. The court, however, expressly rejected the idea that "Congress intended . . . the rapid depreciation provisions of the Revenue laws to amend or modify the express language of the Natural Gas Act . . ." (281 F. 2d, at p. 572). Examining the legislative history, comprehensively, for the second time in this

case, the court below reached the same conclusion (Pet. App. 18a-27a).

Section 167 is a general tax statute applicable to all taxpayers. It gave them the option, for *tax purposes*, of using a more liberal deduction for depreciation. As a taxpayer, Petitioner continues to have the right to use liberalized depreciation in its federal income tax return. Congress did not, however, dictate the regulatory consequences which the Commission must give Petitioner's use of liberalized depreciation in performing the Commission's rate-fixing and rate review functions under the Act.

The tax statute applies to utilities whose operations are subject to the control of state regulatory commissions under statutes that they administer. The regulatory treatment of liberalized depreciation could not be dictated by Congress as to them. Under these circumstances, if Congress intended to proscribe the federal regulatory agency's freedom of selecting the appropriate ratemaking principles, it would be expected to use precise language to accomplish its intent as it did in the Revenue Act of 1964 in prescribing the regulatory treatment for ratemaking purposes of the reduction in taxes resulting from the investment tax credit. Section 203(e), P.L. 88-272, 78 Stat. 19-146. Congress has placed no such restriction in Section 167, thus indicating its intent to enact a tax statute only and to leave the ratemaking treatment to the expert judgment and discretion of the regulatory commissions.

Prior to the adoption of "normalization" for ratemaking purposes, the Commission consistently adhered to the principle that "consumers should be charged for only the actual tax liability for federal income taxes" *United Fuel Gas Company,* 12 FPC 251, 265. The

Commission strayed from this sound regulatory basis for a while because it erroneously believed that Congress had intended to circumscribe the Commission's discretion and expertise. Freed of that error, the Commission re-examined the matter and held on a record fully sustaining its findings that liberalized depreciation results in tax savings, not merely tax deferrals. The Commission is on a sound path again.

2. Petitioner's claim (Pet., p. 11) that it was denied "adequate notice or opportunity to cross-examine or submit rebuttal evidence" was properly rejected by the court below. The claim is contrary to fact and frivolous.

The court below correctly held (Pet. App., p. 38a) that the Association properly and squarely raised the liberalized depreciation issue in the rate hearings before the Commission and that Petitioner "received enough notice of its significance to have protected itself by rebuttal evidence before the end of the hearing." The Association presented expert testimony on the issue and, contrary to the present allegation of Petitioner, it was afforded full opportunity to, and did, cross-examine the Association's expert witness (R. 37-42; Tr. 1404-1410, 1419-1425, 1446-1448). Indeed, Petitioner did not object to the Association's evidence or move to strike it, and made no effort to bar consideration of the issue.

Petitioner presented no evidence in support of its position on the issue. Petitioner chose instead to rest upon Commission precedent, although the issue was highly controversial and was subject to continuing consideration by the Commission. Petitioner, of course, had the right to choose this course, and, in light of the

precedent, it may have been a reasonable one to follow. But, nonetheless, it was a course knowingly undertaken by Petitioner at its own peril. There is no basis, however, for the claim of denial of a fair hearing.

If there lurked in the situation at the hearing any question of procedural due process, the court below correctly found that it "evaporated" as the result of Petitioner's subsequent conduct, and "that the petitioner was not deprived of statutory rights or constitutional due process" (Pet. App., p. 40a). After the Commission severed the issue from the other issues in the rate proceedings and set it for separate consideration, Petitioner made no effort to reopen the proceedings to introduce evidence although the Commission's Rules of Practice and Procedure (18 C.F.R. §§ 1.33(a) and (c) and the Administrative Procedure Act (5 U.S.C. § 1006(e)) make express provision therefor. Had Petitioner done so and been denied the opportunity, there might have been a due process question. But Petitioner never invoked the procedure; nor, in fact, did Petitioner make any request for an opportunity to present evidence at any time during the pendency of the issue before the Commission, even after the issuance by the Commission of the order affirmed by the court below. Moreover, Petitioner did not seek leave of the court below to adduce additional evidence although Section 19(b) of the Natural Gas Act expressly provides therefor.

The Commission had an adequate record before it which the Association made on which to decide the issue as to Petitioner's rates (Pet. App., p. 33a). There was no necessity or requirement for the Commission to reopen the proceedings on its own motion for additional evidence, and none had been brought to its attention by Petitioner. To this day, Petitioner

has never specified the "rebuttal evidence" that would have been adduced or by whom (Pet., p. 19).

CONCLUSION

Federal and state regulatory commissions, exercising their independent judgments, have divided in the selection of the method to be given effect to the use of liberalized depreciation. Some have selected "normalization"; others "flow-through"; some, like the Federal Power Commission, have first chosen "normalization" only to switch to "flow-through" as more experience has been acquired. (FPC Brief in Opposition). The Commission's abandonment of "normalization" and adoption of "flow-through" is not interdicted by any Congressional intent and is supported by substantial evidence. There is no basis for constitutional complaint since the method chosen by the Commission reimburses the utility for its actual federal income tax liability.

Since there is no conflict and since the decision below is correct, there is no more occasion for further review by this Court of the Commission's choice than there was when California in 1961 sought review of the Commission's earlier approval of normalization.

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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